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The Manufacturers Hanover
Economic Report

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Business Conditions Update

If this is an economic recovery, it would be very interesting to see what a recession is like. While the overall economy did expand somewhat during the second quarter as had been widely anticipated, the increase was more statistical than real. Except for a few isolated industries and even fewer regions in the country, there does not seem to be many signs from the real world that activity is picking up. To be sure, this, too, was expected; few economists outside those in the Administration expected the upturn to be anything but mild. But the gloom and doom that pervades the land during what is supposedly the second calendar quarter of an economic upswing would seem to belie even the cautious views of most private-sector economists.

It is important to examine these views in assessing the current economic scene. This is because those indicators that economists normally look at in an effort to divine the future are giving off mixed signals—as they have been for quite some time. Some key statistics are pointing up while others are pointing down. Furthermore, revisions of previously-released data tend to confuse comparisons.

The Statistics Are Mixed

For example, take the overall gross national product. Although the Commerce Department's initial estimate for the GNP adjusted for inflation in the second calendar quarter put the economy's growth at an annual rate of 1.7 percent, other reports issued at about the same time suggest that the economy continued to contract. Industrial production declined in June for the tenth month in the past 11, housing starts fell 15 percent following a one-month increase, and new orders for durable goods fell 1.6 percent (5½ percent for nondefense capital goods). To make matters even worse, there was a sharp drop in retail sales in June following increases during April and May.

If this is not confusing enough, July is the month in which the government revises its figures on the gross national product going back for several years. By definition, revisions result in numbers either becoming higher or lower than earlier estimates. This time, however, most of the revisions were downward—especially for the period beginning in autumn, 1981. Whereas the Commerce Department earlier thought that fourth-quarter 1981's real GNP fell by an annual rate of 4.5 percent compared with the third, it now thinks that the rate of descent was 5.3 percent. Furthermore, first-quarter 1982's real GNP is now believed to be down at a 5.1 percent pace compared with the 3.7 percent clip previously reported. The net result is that the level that the government estimates for second-quarter 1982's GNP—$1,477 billion—while 1.7 percent higher than the revised first quarter, is actually lower than the government's earlier estimates for the first quarter by an annual rate of two percent!

Another factor contributing to the second quarter's "rise" in the GNP was the government's treatment inventories. The way the GNP is put together, an increase in the rate of stockbuilding adds to it while a reduction in the level of inventories is a subtraction. In the first quarter, inventories adjusted for inflation were reduced by $15½ billion at annual rates. In the second quarter they were reduced also—but only by a $7 billion pace. This moderation in selling from inventories translated into an $8½ billion "addition" to the GNP between the first and the second quarters—hardly the beginning of an economic recovery.

Looking at data for the first few weeks of the third quarter suggests that the weakening in June has continued. Most key statistics describing the production of goods and energy, transportation, business activity and employment levels worsened during the month of July. Of course, since July is a month when many plants close for vacation, this comparison is being made after taking normal seasonal developments into account.

NO REPORT IN AUGUST

The monthly Economic Report will not be published during August. The next issue will appear in September.

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In the minds of consumers and businessmen, the economy may still be heading south. To be sure, business sentiment is not considered a leading—or even a coincident—economic indicator. Businessmen tend to see changes in economic trends long after they have taken place. But for attitudes to worsen as the economy turns up is most unusual. Furthermore, consumer attitudes tend to be more in tune with the pace of the economy (not surprising, since consumer spending accounts for two thirds of the GNP) and public confidence is none too good at the present time.

Why Attitudes Are Gloomy

A lot of reasons could be advanced for these sour attitudes. Disillusionment with Reaganomics is an obvious choice; concern over high interest rates is no doubt a factor, too. Of course, there is nothing wrong with business attitudes that a few more orders could not cure. However, these increased orders are unlikely to occur in the present environment. Because of weakness in exports, residential construction and domestic automobile sales, it is not surprising that businessmen's inclination to invest in capital goods is much reduced. It may be true that plant and equipment spending typically lags an upturn in overall economic activity, but at the moment it is dragging things down. Most businesses, it seems, are cutting back planned projects, either by stretching them out, or by canceling them altogether.

What is significant is that this back-pedaling on capital investment has occurred despite incentives provided by the Administration since early last year. "Real" nonresidential fixed investment as measured in the GNP accounts has declined for six months now, dropping at a seasonally adjusted annual rate of 8.5 percent in second-quarter 1982. Companies have been struggling with a downturn in sales, excess inventories and the high cost of borrowing. By cutting production some ten percent since last July, businessmen have idled more than 30 percent of capacity in the nation's factories, all but eliminating the need for expansion.

Ironically, one development that would ordinarily be cheered has caused some people's moods to sour. This is the sudden and dramatic slowing of inflation. It would seem that most people do not think that the rate of inflation is any slower today than it was a year ago —at least according to some surveys. But inflation has slowed—notwithstanding the monthly increases of one percent each in May and in June at the consumer level. For at the wholesale or business level, inflation has all but disappeared as producer prices rose at a 2½ percent annual rate over the first six months of this year compared with a 10 percent pace in the first six months of 1981.

Going further back to the basic commodity level, one finds not inflation, but deflation. Commodities prices have been falling for the better part of the past two years. Such key commodities as copper, aluminum, paperboard and scrap steel, have posted lows not seen in recent memory. An overall index of industrial raw materials' prices formerly produced by the Bureau of Labor Statistics and now carried on by the Commodity Research Bureau shows that sensitive industrial materials' prices in the aggregate are no higher today than they were in 1974.

This deflation—or, at the very least, disinflation—has hit business management like a ten-ton truck. It seems that inflation had helped management in many ways, and its absence is apparently hurting. Quoting from the Manufacturers Hanover Economic Report of June, 1981: "Inflation allows businessmen to raise their prices without losing customers, since people are more likely to accept higher prices in an inflationary environment than when prices are stable. Naturally, inflation will boost the dollar value of sales and earnings thus making many a manager look good—at least on the surface ... Many businessmen look to inflation as a cushion, in that they can pass along increases in costs more readily in an inflationary environment than in an era of price stability." (That Economic Report, by the way, suggested that there were many other groups in the country besides businessmen who have learned to live with inflation—if not depend on it. These groups are obviously hurting because of inflation's slowing yet dare not suggest that policymakers pump up the price level once again since price stability is a "motherhood and apple pie" issue. Not surprisingly, such mixed emotions have also confused and depressed people.

Where Will The Strength Come From?

Considering these attitudes and their sources, it is nothing short of amazing that there are forecasters who believe that a strong upturn is highly likely in the second half of 1982. Some of these forecasters work for the government, so their optimism should not be surprising. However, others are in the private sector, where, presumably, a more objective view can be taken. Let us therefore examine their arguments to see just how credible they are.

Those who have a simple model dealing with the money supply and its relationship to economic activity are looking for a pickup in second-half 1982. They point to the growth that the Federal Reserve says it will allow in the monetary aggregates and add to it the increase in velocity (turnover of money) that usually occurs at this point in a business recovery. However, they fail to take into account the fact that the demand for money continues to overwhelm the supply—even with increased velocity. For one thing, most borrowing by the private sector is being concentrated in the short-term markets where money first surfaces. Because of an inability or an unwillingness to access the

long-term markets, business is forced to concentrate its fund raising in the short-term markets. This means, of course, that the volume of borrowing is enlarged because of the shortness of the duration of the loans.

Then there is Washington and its associated credit needs. Net new Treasury cash requirements are likely to exceed $100 billion in the second half of this year alone, well above the $60 billion raised during the comparable 1981 period. In the first three weeks of July, net Treasury borrowings surpassed $17 billion—$5½ billion more than the net amount raised in all of second-quarter 1982!

Under these circumstances, an economic recovery could cause further imbalances between the demand for money and its supply. Normally, business loan demand drops in the later stages of a recession and the early months of an economic recovery as lower interest rates, augmented by improved cash flow, permit business to reduce its short-term debt. But interest rates are still high and the economy remains weak. As a result, short-term debt continues to grow, while cash flow continues to decline.

The dramatic slowing of inflation will delay any improvement in cash flow. This is because it will prevent business from raising prices at the first sign of firmer markets. Government borrowing usually is not reduced in the early stages of an economic recovery since tax revenues are affected only with a lag. For their part, household borrowings might rise if consumers were to expand their purchases of anything but small-ticket items. Thus it would seem that the money supply argument is not convincing, insofar as it being a reason to expect a recovery in economic activity.

What about the consumer, especially since people have just gotten a boost in their after-tax income from the ten percent cut in tax rates and the 7½ percent rise in Social Security Benefits? Well for one thing, the amounts involved are so small that they are unlikely to be spent immediately. No family's take-home pay was increased by more than $13.40 a week; for most it was considerably less—while for the average family it was $4.38! Show me the person who goes out and makes a major purchase based on these sums and I will show you an optimist.

Besides its small size, this tax cut is being overwhelmed by increases in taxes, fees and public utility rates at the state and local level. Those macroeconomic models that only factor in the cut in Federal tax rates in calculating changes in disposable personal incomes and ignore what is going on at the state and local level will produce results at variance with reality.

If the consumer does not come through and lift his outlays dramatically starting this quarter, then business inventories may not be in as good shape as some think. True, the inflation-adjusted level of business inventories was reduced by an annual rate of $11 billion in first-half 1982. But this only offset the $11 billion rise in real inventories that occurred in second-half 1981. Meanwhile, real final sales at midyear 1982 were $6½ billion lower than they were a year earlier. This left the ratio of inventories to sales adjusted for inflation at 1.8 months' sales, compared with 1.7 one year earlier—hardly an indication that stocks are low enough relative to sales to encourage increased rates of production.

Even if the consumer does increase his spending somewhat over the coming months, the type of goods that he is likely to buy will not contribute much to the economic recovery. This is because high interest rates and reduced confidence will cause people to concentrate on such "small-ticket" items as video games, personal radios, clothing and so forth. Besides the fact that a lot of these goods are made overseas, those that are produced here are so small that they take a long time before they translate into a need on the part of business to increase production lines to the point where capital spending pressures develop.

Conclusion

Putting it all together, I find it difficult to come up with enough sources of strength to push the economy ahead by more than a snail's pace over the next few calendar quarters. This would be in distinct contrast with previous economic recoveries, where the GNP in real terms would be climbing at a ten percent annual rate or greater early in an economic recovery. The slow pace of the ongoing rebound makes it susceptible to any unusual development that could strike the economy such as bad weather here or abroad, a sudden change in oil prices and/or supplies or another bout of monetary instability which could cause the money supply to jump upward and the markets to boost interest rates in anticipation of a tightening by the Fed to pull the money aggregates back down.

Needless to say, politics, already very much an influence on economic activity, could impact the recovery even further. Congress continues to find it difficult to cut spending and increase revenues enough to reduce the budget deficit. For its part, the Administration refuses to budge on its tax cut program, or on defense spending. These political developments do not generate confidence among financial market participants that the government's financing needs can be reduced. Unless the public sector reduces its needs for funds, the private sector cannot expand its borrowings while the Federal Reserve remains committed to a tight money policy. We must have a political compromise in order for the economy to strengthen—and the sooner, the better. H

July, 1982

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	< Actual				Projected >							
	1981		YEAR 1981		1982				YEAR 1982		1983	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2980.9	3003.2	**2937.7**	**11.6**	2995.5	3047.4	3115.2	3163.3	**3080.4**	**4.9**	3221.4	3292.6
GNP: $72	1510.4	1490.1	**1502.6**	**1.9**	1470.7	1476.8	1484.4	1485.7	**1479.4**	**−1.5**	1493.0	1503.7
% Change, Annual Rates	2.2	−5.3	**1.9**		−5.1	1.7	2.1	0.4	**−1.5**		2.0	2.9
Consumption	1868.8	1884.5	**1843.1**	**10.6**	1919.4	1950.8	2003.6	2039.5	**1978.3**	**7.3**	2082.8	2114.4
Durables	241.2	229.6	**234.5**	**9.4**	237.9	242.6	253.1	255.0	**247.1**	**5.4**	264.0	264.3
Non-Durables	741.3	746.5	**734.5**	**9.6**	749.1	756.5	777.2	789.4	**768.1**	**4.6**	803.0	812.2
Services	886.3	908.3	**874.1**	**11.7**	932.4	951.6	973.2	995.1	**963.1**	**10.2**	1015.8	1038.0
Investment	486.0	468.9	**471.5**	**17.2**	414.8	429.1	436.2	434.0	**428.5**	**−9.1**	447.1	476.6
Non-Residential	353.0	360.2	**346.1**	**12.0**	357.0	354.0	341.6	329.6	**345.6**	**−0.2**	337.2	347.8
Producers Durable Equipment	220.2	220.6	**216.4**	**8.9**	215.6	210.8	203.1	197.7	**206.8**	**−4.4**	205.6	214.4
Structures	132.7	139.6	**129.7**	**17.4**	141.4	143.2	138.5	131.9	**138.8**	**7.0**	131.6	133.4
Residential	101.2	95.5	**105.0**	**1.7**	93.4	94.7	104.6	109.1	**100.5**	**−4.3**	112.9	124.9
Inventory Changes	31.8	13.2	**20.4**		−35.6	−19.7	−10.0	−4.7	**−17.5**		−3.0	3.8
Net Exports	25.9	23.5	**26.1**		31.3	35.6	34.6	34.9	**34.1**		27.1	27.4
Government Purchases	600.2	626.3	**597.0**	**10.9**	630.1	631.9	640.8	655.0	**639.5**	**7.1**	664.4	674.2
Federal Defense	154.4	166.9	**153.7**	**17.0**	166.2	172.2	176.7	183.2	**174.6**	**13.6**	190.1	194.9
Federal Civilian	75.7	83.6	**75.2**	**14.3**	83.5	71.9	71.0	73.2	**74.9**	**−0.4**	74.1	73.9
State & Local	370.1	375.7	**368.0**	**7.8**	380.4	387.8	393.1	398.6	**390.0**	**6.0**	400.2	405.4
Final Sales: $72	1493.9	1485.3	**1493.7**	**1.0**	1486.1	1483.7	1489.0	1487.8	**1486.7**	**−0.5**	1494.3	1502.2
% Change, Annual Rates	1.0	−2.3	**1.0**		0.2	−0.6	1.4	−0.3	**−0.5**		1.7	2.1
GNP Price Index (1972 = 100)	197.4	201.6	**195.5**	**9.4**	203.7	206.4	209.9	212.9	**208.2**	**6.5**	215.8	219.0
% Change, Annual Rates	9.0	8.8	**9.4**		4.3	5.3	7.0	5.9	**6.5**		5.4	6.1
PCE Deflator (1972 = 100)	196.4	199.8	**194.5**	**8.6**	202.2	204.0	207.4	210.3	**206.0**	**5.9**	213.5	216.6
% Change, Annual Rates	8.1	7.1	**8.6**		4.9	3.6	6.9	5.7	**5.9**		6.3	5.9
Consumer Price Index (1967 = 100)	276.2	281.4	**272.4**	**10.3**	283.6	286.8	293.0	297.2	**290.1**	**6.5**	302.0	306.4
% Change, Annual Rates	11.8	7.8	**10.3**		3.2	4.6	9.0	5.8	**6.5**		6.7	6.0
Total Personal Income	2458.0	2494.6	**2415.8**	**11.8**	2510.4	2549.5	2614.5	2654.3	**2582.2**	**6.9**	2702.9	2758.0
Disposable Personal Income	2060.0	2101.4	**2029.1**	**11.2**	2117.1	2151.9	2236.7	2267.3	**2193.3**	**8.1**	2303.2	2340.1
Savings Rate	6.5	7.5	**6.4**		6.6	6.6	7.7	7.3	**7.0**		6.8	6.8
Employment Rate	58.9	58.3	**58.8**		57.9	57.8	57.9	58.1	**57.9**		58.2	58.3
Unemployment Rate	7.4	8.4	**7.6**		8.8	9.5	9.6	9.4	**9.3**		9.3	9.3
Indus. Production (1967 = 100)	153.0	146.3	**150.9**	**2.6**	141.8	139.3	139.6	140.4	**140.3**	**−7.0**	142.9	145.5
Housing Starts (000)	961.7	865.3	**1099.8**	**−15.3**	920.3	956.0	1056.7	1075.1	**1002.1**	**−8.9**	1170.6	1332.7
Domestic Auto Sales (000)	6933.3	5184.0	**6271.0**	**−4.9**	5966.7	5466.7	5811.1	5759.8	**5751.1**	**−8.3**	6485.9	6318.2
Corporate Pre-Tax Profits	233.3	216.5	**232.1**	**−4.3**	171.6	164.7	172.6	169.4	**169.6**	**−26.9**	171.6	182.2
−Taxes	82.4	71.6	**81.2**	**−4.1**	55.8	51.2	55.5	54.8	**54.3**	**−33.1**	58.7	62.7
Net Profits	150.8	144.9	**150.9**	**−4.4**	115.9	113.5	117.1	114.7	**115.3**	**−23.6**	112.9	119.5
−Dividend Payments	66.8	68.1	**65.1**	**12.1**	68.8	69.3	70.1	71.0	**69.8**	**7.2**	71.9	73.1
Undistributed Profits	84.0	76.9	**85.8**	**−14.0**	47.0	44.2	47.0	43.7	**45.5**	**−47.0**	40.9	46.5
+Depreciation	192.6	200.5	**189.3**	**15.9**	208.8	217.4	224.8	234.3	**221.3**	**16.9**	245.2	252.8
−Inventory Profits	23.0	17.1	**24.6**	**−42.8**	4.4	6.3	8.9	11.1	**7.7**	**−68.8**	11.9	13.1
Net Cash Flow	253.6	260.3	**250.6**	**13.8**	251.4	255.3	262.9	266.9	**259.1**	**3.4**	274.2	286.2